IN THE

Supreme Court of The United States

OCTOBER TERM, 1977

No. 77-255

SUNDSTRAND CORPORATION,

Petitioner

vs.

SUN CHEMICAL CORPORATION, RAYMOND F. RYAN and THOMAS B. HART, JR., Executors of the Estate of John B. Huarisa,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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* Several of the opinions and orders entered in this litigation have been printed in the appendix to the petition for a writ of certiorari filed by Henry W. Meers (cited herein as "M. App._____"), No. 77-83, and are therefore not reprinted in this appendix. The appendix of petitioner Sundstrand Corporation, the pages of which are numbered consecutively following those of the Meers appendix (M.App. 1-109), begins at App. 110.

** Each page in the trial record cited by the Court of Appeals in Footnote 35, as amended, is included in full in this appendix, although some pages begin or end in the middle of a sentence, question, or answer.

TABLE OF AUTHORITIES

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Petitioner Sundstrand Corporation respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on February 23, 1977 insofar as it pertains to defendants-respondents Sun Chemical Corporation, and Raymond F. Ryan and Thomas B. Hart, Jr., executors of the estate of John B. Huarisa.*

* Petitioner does not seek review of the judgment below insofar as it relates to defendant Henry W. Meers. Since respondents were far more deeply involved in the fraudulent conduct than was Meers during the time period upon which this petition focuses, the issues which petitioner seeks this Court to consider are more clearly presented by limiting the petition to these respondents. Meers has filed a petition for a writ of certiorari (Case No. 77-83) to which Sundstrand Corporation has responded.

OPINIONS BELOW

The opinion of the Court of Appeals is officially reported at 553 F.2d 1033 and is printed in the appendix to the petition for a writ of certiorari filed by Henry W. Meers in Case No. 77-83. (M.App 72-107)* The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, from which that appeal was taken, is not officially reported and is printed at M.App. 2-71. A prior opinion of the Court of Appeals in this action, not pertinent to the issues presented by this petition, is reported *sub nom. Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.* at 488 F.2d 807 (7th Cir. 1973). All references herein to the Court of Appeals' opinion are to the more recent opinion.

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit sought to be reviewed was entered on February 23, 1977. (M.App. 108) A petition for rehearing and suggestion of rehearing en banc was filed by petitioner herein on March 29, 1977.** The petition for rehearing was denied on May 18, 1977.*** This petition for certiorari is filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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* On April 18, 1977 and May 18, 1977 the Court of Appeals entered orders which provided for certain additions to the opinion of February 23, 1977. The opinion as officially reported reflects all such changes. The opinion as reprinted in the appendix to the petition in Case No. 77-83 (hereinafter "M.App.") does not reflect those changes. The Order of April 18, 1977 is set forth in full at M.App. 109. The Order of May 18, 1977 is set forth in full in the appendix to this petition (hereinafter "S.App.") at S.App. 110-11. Footnote 35 of the opinion of the Court of Appeals, as amended, appears at S.App. 112.

** On March 3, 1977 the Court of Appeals granted petitioner an extension of time until March 29, 1977 within which to file a petition for rehearing. That petition was directed only to the defendants who are respondents herein.

*** One member of the panel which decided the appeal voted for rehearing. One of the other Circuit Judges who considered petitioner's suggestion for rehearing en banc voted for rehearing. (S.App. 110-11)

QUESTIONS PRESENTED

1. May a plaintiff-purchaser of securities who acted in reliance on defendants' fraudulent conduct in violation of Securities and Exchange Commission Rule 10b-5, and who acted without any knowledge of that fraud, be deprived of damages resulting from that fraud because another cause may have contributed to the purchaser's consummation of the transaction which resulted in the damages?*

2. Where the defendant deliberately committed a fraud in violation of Securities and Exchange Commission Rule 10b-5, can a plaintiff-purchaser be deprived of damages resulting from that fraud on the ground that the purchaser acted negligently in consummating the purchase?

3. Can a Court of Appeals make an "independent study" of material not in the trial record in order to make findings of fact contrary to findings made by the District Court?

STATUTE AND RULE INVOLVED

Sections 10(b) and 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78cc(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, are set forth in the appendix hereto (S.App. 113-114).

STATEMENT OF THE CASE

In August, 1969 petitioner Sundstrand Corporation ("Sundstrand") filed its complaint against Standard Kolls-

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* As presented by Question No. 3, petitioner contends that there was no evidence of any cause other than petitioner's reliance on respondents' fraud. For purposes of Question No. 1, however, the existence of another cause is assumed *arguendo*.

man Industries, Inc. ("SKI"),* John B. Huarisa ("Huarisa"),** chief executive officer of SKI, and Henry W. Meers ("Meers"), a director of SKI, alleging that all three defendants had violated Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 CFR § 240.10b-5, in connection with Sundstrand's purchase of 223,190 shares of SKI stock in early 1969. The District Court's jurisdiction of the action was predicated on Section 27 of the 1934 Act, 15 U.S.C. § 78aa.

At the first trial of this action, in 1971, Sundstrand's claim was dismissed at the close of its evidence. That ruling was reversed. 488 F.2d 807 (7th Cir. 1973).

At the second trial, the District Court, sitting without a jury, found all defendants liable and entered judgment against them in the amount of $4,434,786 plus prejudgment interest. The Court of Appeals affirmed the judgment and findings of liability in all respects but reduced the amount awarded to plaintiff-petitioner to $334,785 plus prejudgment interest, a reduction of 93%. Petitioner seeks review of that Court of Appeals decision insofar as it reduced the amount of the District Court's judgment against defendants Sun and Huarisa's executors.

The fraudulent conduct of defendants which gave rise to the findings of liability by the courts below involves misrepresentations and omissions concerning the financial condition of SKI in late 1968 and early 1969. Sundstrand's involvement began in late 1968 but earlier events are pertinent to an understanding of the pervasive fraud.

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* In December, 1972, SKI was merged into respondent Sun Chemical Corporation ("Sun"). As successor to the liabilities of SKI, Sun was substituted for SKI as a defendant.

** In May, 1975, Huarisa died. His executors, respondents Raymond F. Ryan and Thomas B. Hart, Jr., were substituted for him as defendants.

1. Questions Concerning SKI's Accounting Practices

By year-end 1967, Kollsman Instrument Corporation ("KIC"), SKI's principal subsidiary, had deferred substantial preproduction costs in connection with programs for the production of certain aircraft instrumentation. In mid-1968, after publication of SKI's 1967 annual report reflecting these deferrals, James W. Burke, a director and large shareholder of SKI, and one of SKI's other directors, raised questions regarding the propriety of SKI's accounting practices and the accuracy of the financial statements. Burke formally submitted questions to the SKI board regarding those matters (the "Burke report"), as well as a report critical of SKI's accounting practices which had been prepared by the accounting firm of Ernst & Ernst (the "Ernst & Ernst report"), which Burke had retained. However, no changes were made in the accounting practices, and SKI deferred substantial additional preproduction costs throughout 1968. (Dist. Ct. at M.App. 30-32; Ct. Ap. at M.App. 83-84, 95-97)

2. SKI's Grossly False Nine-Month's Report

On November 4, 1968, SKI published its quarterly report to shareholders for the nine months ended September 30, which stated that SKI had income before taxes of $4,350,039 for the first nine months of the year with net income after taxes equivalent to $.86 per share. These figures were not audited or reviewed by Price Waterhouse & Co., SKI's independent accountants. In fact, as the District Court found, and as affirmed by the Court of Appeals, the reported nine months earnings of SKI and its subsidiaries were deliberately grossly overstated, since SKI should have reported income before taxes of only $633,756 for that period, or approximately $.12 per share after taxes. (Dist. Ct. at M.App. 34-48; Ct. Ap. at M.App. 82 n. 8)

3. Merger Negotiations Between Sundstrand and SKI and Further Misrepresentations by Defendants

In the late summer of 1968 Huarisa and SKI were searching for a company suitable for a merger with SKI. In mid-November, 1968, after publication of the third quarter report, and pursuant to Huarisa's authorization, Meers, an SKI director, contacted Sundstrand to see if it was interested in a merger with SKI. Thereafter, a number of meetings were held in November and December, 1968 among representatives of Sundstrand and Huarisa and other SKI representatives. During these meetings Huarisa represented to Sundstrand that SKI's earnings for the first three quarters of 1968 were $.86 per share, as reported in the published nine months' earnings statement. Huarisa also told Sundstrand that SKI's net income for all of 1968 would be between $2,600,000 and $2,900,000, that SKI's 1968 earnings per share would be about $1.16, and that SKI's earnings for the year 1969 would be about $2.41 or even $2.50 per share. Huarisa provided a written projection to Sundstrand which showed 1969 earnings of $2.13 per share. Huarisa also stated that in no case would there be adjustment to 1968 earnings which would reduce them below the $.86 per share already reported. As both the District Court and the Court of Appeals held, Huarisa and SKI knew or were reckless in not knowing that the 1968 and 1969 earnings projections were grossly inflated. (Dist. Ct. at M.App. 7-11, 28-30, 60; Ct. Ap. at M.App. 76-77, 82)

Thereafter, Sundstrand representatives commenced merger negotiations with Huarisa and Meers which culminated in an offer by Sundstrand for the assets of SKI subject to its liabilities for Sundstrand stock equivalent to $38.25 per SKI share. This proposal was subject to, *inter alia*, Sundstrand's conducting a survey of the business of SKI. On January 2, 1969, the SKI board authorized Hua-

risa to proceed on the basis of the Sundstrand proposal. (Dist. Ct. at M.App. 10-13; Ct. Ap. at M.App. 77)

4. Huarisa's Right of First Refusal

Huarisa owned a block of SKI stock and a right of first refusal on additional shares of SKI common stock owned by the Burke family interests. On December 10, 1968 Huarisa had received from the Burke family an offer to sell to him, at $30 per share, 223,190 shares of SKI stock covered by Huarisa's right of first refusal. Under that right Huarisa had 30 days within which to exercise his right by paying 5% of the purchase price. Otherwise, Sun, which had made the offer to the Burkes, would have an unconditional right to purchase the stock. (Dist. Ct. at M.App. 5, 13-14; Ct. Ap. at M.App. 75)

On January 4, 1969, Huarisa first informed Sundstrand that there was a right of first refusal which had been triggered by an offer by a third party. At a meeting on January 6, 1969 Huarisa advised Sundstrand that if Sun acquired the stock from the Burkes, Sundstrand and SKI would have to forget about the proposed merger. As both courts below held, after receiving Huarisa's confirmation that SKI's 1968 and 1969 earnings projections still looked good, Sundstrand orally agreed to acquire Huarisa's right of first refusal on 223,190 shares of SKI stock at $30 per share. (Dist. Ct. at M.App. 13-15, 18; Ct. Ap. at M.App. 75, 85-87, 102)

Accordingly, on January 8, 1969 Huarisa exercised his right of first refusal by delivering to the Burke family his written election to purchase and $334,785 in cash, representing 5% of the purchase price. On January 9, 1969 Sundstrand and Huarisa entered into a written agreement reflecting the oral agreement of January 4, 1969. (Dist. Ct. at M.App. 15-16; Ct. Ap. at M.App. 75-76)

5. Sundstrand's Survey of SKI and Still Further Misrepresentations and Omissions

Sundstrand undertook a survey of SKI to determine whether or not the merger should be consummated. As both the District Court and the Court of Appeals held, the financial information regarding KIC and SKI which was provided to Sundstrand during the survey and on which Sundstrand relied was deliberately restricted and was misleading, and Huarisa and the principal financial officers of SKI and KIC, including Raymond Ryan, conspired to prevent Sundstrand from discovering SKI's true financial condition. Indeed, Sundstrand's questions about SKI's financial condition were often answered with outright lies. (Dist. Ct. at M.App. 19-22, 48-57; Ct. Ap. at M.App. 77, 79, 82, 84 n. 10)

6. Termination of Merger Negotiations and Stock Purchase

After Sundstrand personnel evaluated the information provided by SKI, they concluded on January 20, 1969 that certain aspects of the proposed transaction, including an increase in labor costs which a merger would cause, undesirable SKI labor practices and lack of the expected compatibility of SKI's and Sundstrand's products, and a belief on the part of Sundstrand that SKI's earnings projections were somewhat optimistic, made the acquisition unattractive. A decision was then made to cancel the negotiations. (Dist. Ct. at M.App. 22-23; Ct. Ap. at M.App. 77)

Despite further misrepresentations and omissions regarding SKI's financial condition by Huarisa and Ryan at meetings on January 20 and 22, 1969, Sundstrand adhered to its decision to call off the merger negotiations. However, at the close of the January 22 meeting Sundstrand's president indicated that Sundstrand was going to purchase the shares covered by the right of first refusal. On February 6, 1969 Sundstrand made its payment of $6,360,915 for the

223,190 shares of SKI common stock. Both Huarisa and Ryan were aware of and participated in the consummation of that transaction. (Dist. Ct. at M.App. 23-25, 48 *et seq.*; Ct. Ap. at M.App. 78-79, 82-85)

7. SKI's Massive 1968 Loss and Sundstrand's Discovery of the Misrepresentations and Omissions

On March 21, 1969 SKI published its 1968 annual report which reported an after tax *loss* of $798,803, equivalent to a loss of $.15 per share after taxes (M.App. 25), as contrasted with Huarisa's earlier projection of a profit of $1.16 per share. The disparity between the previously reported earnings and the loss was caused by substantial write-offs taken as of year-end 1968.

After the foregoing events, and only in pre-trial discovery herein, Sundstrand learned that during January and early February 1969, Price Waterhouse was advising SKI, Huarisa and other officers of SKI that substantial year-end write-offs would have to be made on the books of SKI, which would adversely affect SKI's earnings for 1968 by several million dollars. Several days prior to Sundstrand's cash payment of $6,360,915 for the SKI stock on February 6, 1969, Ryan, principal financial officer of SKI, and his counterpart at KIC received a memorandum from Price Waterhouse stating its preliminary assessment that write-offs in the range of $3 million to $4.5 million would have to be made on the books of SKI as of year-end 1968 and stating that it was encountering new areas of concern almost daily. As the District Court found and the Court of Appeals affirmed, Huarisa also knew of this assessment before February 6, 1969. (Dist. Ct. at M.App. 48-51; Ct. Ap. at M.App. 84-85) Yet, no one—neither Huarisa nor Ryan nor anyone else—disclosed the Price Waterhouse assessment to Sundstrand. The Court of Appeals held that "[t]he memorandum should have been disclosed to Sund-

strand." (M.App. 84) In large part the write-offs accounting for the difference between the fraudulent profit projection made to Sundstrand and the actual loss had been outlined in the undisclosed Price Waterhouse memorandum. In addition, only in March, 1969, after the loss for 1968 was reported, did Sundstrand learn of James Burke's criticisms of SKI's accounting practices and of the Burke and Ernst & Ernst reports. Those reports had criticized the deferral of certain preproduction costs which were part of the substantial write-offs as of year-end 1968. (Dist. Ct. at M.App. 25-26; Ct. Ap. at M.App. 83-84, 95-97)

8. The District Court's Findings and Judgment

After a lengthy trial the District Court held in an extensive opinion that all of the defendants had violated Rule 10b-5 in misrepresenting material facts to Sundstrand and failing to disclose material facts to Sundstrand through the date of Sundstrand's purchase of the SKI stock on February 6, 1969. (M.App. 60 *et seq.*) The District Court found that SKI and Huarisa intentionally overstated earnings as of September 30, 1968, recklessly projected earnings for 1968 and 1969 and deliberately withheld the Price Waterhouse memorandum and the Burke and Ernst & Ernst reports. The District Court also held that Sundstrand had no knowledge of these misrepresentations and omissions prior to the purchase. (M.App. 57)

The District Court thus concluded that Sundstrand had been wrongfully induced to purchase the SKI stock. It ruled that the damages were the difference between the amount paid for the SKI stock and its actual value. The District Court awarded damages of $4,434,786, plus prejudgment interest at the rate of 6% per annum from February 6, 1969. (M.App. 70-71) (As of the date of this petition that judgment would aggregate over $6,700,000.)

9. The Court of Appeals' Opinion and Judgment

All defendants appealed from the judgment of the District Court. The Court of Appeals affirmed the judgment of liability as to all defendants in all respects. However, the Court of Appeals held that Sundstrand was only entitled to recover damages with respect to the initial payment for the stock made by Sundstrand as a result of its January 9, 1969 agreement with Huarisa, namely $334,785, plus prejudgment interest at 6% per annum from January 9, 1969. (M.App. 106-108) (On July 21, 1977, the amount of that judgment was paid by Sun. By this petition Sundstrand seeks to recover the balance of the judgment awarded by the District Court.)

The sole rationale for the reduction in damages by over 90% was the Court of Appeals' *sua sponte* finding that the "only" or "principal" reason why Sundstrand completed the purchase of the stock on February 6, 1969 was that Sundstrand had relied on an erroneous opinion of counsel to the effect that under the January 9, 1969 agreement between Sundstrand and Huarisa, Sundstrand was obligated to complete the purchase.* The District Court had made no findings as to any such opinion, and the parties had not briefed such an issue on appeal. (M.App. 103-104) This ruling by the Court of Appeals that there was a "superseding cause"—based upon its "independent study of the record"—was contrary to the express findings by the District Court that Sundstrand continued to rely upon the misrepresentations and omissions made by the defendants when Sundstrand made its final payment for the stock in question, on February 6, 1969, that such reliance was entirely reasonable, and that Sundstrand did not begin to learn the truth regarding defendants' fraud or the horrendous financial condition of SKI until late March, 1969. (M.App. 56-58)

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* Both the District Court and the Court of Appeals had concluded that Sundstrand was not obligated to make any further payments under the agreement with Huarisa after reimbursing him for the downpayment he had made. (Dist. Ct. at M.App. 18, 25; Ct. Ap. at M.App. 102)

REASONS FOR GRANTING THE WRIT

Each of the three reasons for granting the requested writ of certiorari involves not only an erroneous ruling below but a direct conflict between the decision below and the decisions of other Courts of Appeals on significant matters involving the federal securities laws and the scope of appellate review. The decision below also conflicts with decisions of this Court. Review by this Court is necessary to resolve these conflicts and to correct the errors below.

I. The Causation Analysis Upon Which The Seventh Circuit's Decision Rests Is In Conflict With This Court's Decisions Under The Federal Securities Laws And With Decisions In Other Circuits, And Is Demonstrably Erroneous

The ruling below ignored the principles of causation applicable to actions under Rule 10b-5 enunciated by this Court and by other Courts of Appeals in holding that the presence of an additional cause, i.e. a cause in addition to plaintiff's reliance on defendants' misconduct, precludes recovery in an action under Rule 10b-5 even where the plaintiff-purchaser had no knowledge of the deliberate misrepresentations and omissions perpetrated by the defendants. Review of the decision below is necessary to clarify the applicable principles of causation and to correct this error, just as this Court has recently resolved the three other principal legal issues in private actions under Rule 10b-5.* This case presents a particularly favorable setting for a definitive resolution of causation standards in such cases. No issue of fact is presented by Question No. 1, since,

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* The principal legal questions which have arisen in cases under Rule 10b-5 are plaintiff's standing, the culpability required on the part of the defendant, the definition of a "material" fact and the relevance of traditional tort concepts of causation, including reliance. This Court has recently specifically addressed itself to the first three of these issues. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 183 (1976); and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (under SEC Rule 14a-9, 17 C.F.R. § 240.14a-9).

for purposes of this issue, petitioner accepts *arguendo* the Court of Appeals' erroneous and unsupported finding that petitioner had relied on an opinion of counsel in consummating the transaction. (*See* pp. 21-23, *infra*)

Although there was some analysis of causation in actions under Rule 10b-5 in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), much confusion remains surrounding the application of traditional tort principles of causation in such actions. For example, *compare Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238-242 (2d Cir. 1974), with *Fridrich* v. *Bradford*, 542 F.2d 307, 316-320 (6th Cir. 1976), *cert. denied*, 97 S.Ct. 767 (1977). *See generally* 1 A. Bromberg, *Securities Law: Fraud*, Secs. 4.7(550) *et seq.* (1973); 5 Jacobs, *The Impact of Rule 10b-5*, § 64.02 (1976). *See also* cases cited at pp. 17-18, *infra*. While some of the cited cases involve causation issues in contexts other than that presented by the instant case, the need for this Court to clarify causation standards in actions under Rule 10b-5 is apparent. Moreover, since this case involves a single plaintiff defrauded in a face-to-face transaction (as distinguished from, e.g., a class action or an open market transaction), it presents more fundamental issues than do many other cases in which causation questions arise, and therefore is particularly suitable for consideration by this Court.

A. The Decision Below Is In Conflict With This Court's Decision In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), And With Decisions Of Other Circuits

The correct application of this Court's analysis of causation in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), to the facts of this case can be demonstrated by a single but crucial example of an actionable non-disclosure. Both the Court of Appeals and the District Court held that SKI and Huarisa intentionally withheld from Sundstrand

the January 27, 1969 Price Waterhouse memorandum, an obviously material document which indicated huge anticipated write-offs at year-end 1968 about which Sundstrand had no knowledge. Both courts also held that Huarisa and Ryan knew of the memorandum and knew that Sundstrand was about to pay the balance of the purchase price for the SKI stock which was subject to the right of first refusal. (Dist. Ct. at M.App. 24, 49-50; Ct. Ap. at M.App. 78, 84) "This obligation to disclose and this withholding of a material fact established the requisite element of tort causation in fact." *Affiliated Ute Citizens, supra,* 406 U.S. at 154 (1972).* *See also Piper* v. *Chris-Craft Industries, Inc.,* 97 S.Ct. 926, 953-54 (1977) (Blackmun, J., concurring in the judgment).

Many lower federal courts have held that reliance upon the misrepresentation or omission at issue need not be the *sole* cause of plaintiff's damage in order to sustain a cause of action under Rule 10b-5; it need only be a substantial factor. *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* 540 F.2d 27, 34 (2d Cir. 1976); *Mitchell* v. *Texas Gulf Sulphur Co.,* 446 F.2d 90, 102 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 (1972); *McLean* v. *Alexander,* 420 F.Supp. 1057, 1077 (D.Del. 1976); *see also Zenith Radio Corp.* v. *Hazeltine Research, Inc.,* 395 U.S. 100, 114 n. 9 (1969) ("It is enough that the illegality is shown to be *a* material cause of the injury. . . ."; emphasis added).

Under the *Affiliated Ute Citizens* presumption and the cases cited in the preceding paragraph, the conduct referred to above, as well as respondents' other acts in violation of Rule 10b-5, constitutes at least *a* cause of Sundstrand's

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* While proof that plaintiff had actual knowledge of the omitted facts (*Sanders* v. *John Nuveen & Co., Inc.,* 524 F.2d 1064, 1073 (7th Cir. 1975), *vacated and remanded on other grounds,* 425 U.S. 929 (1976)) or that plaintiff would have made the purchase even if he had known the undisclosed facts (*Rochez Bros., Inc.* v. *Rhoads,* 491 F.2d 402, 410-11 (3d Cir. 1974)) might rebut the *Affiliated Ute Citizens* presumption of causation, neither circumstance was present here. (M.App. 57) *See also pp. 17-20, infra.*

purchase of the SKI stock and *a* cause of the resulting loss. No more need be proven. Under the cases cited in the preceding paragraph, even if some other cause (e.g. reliance on a legal opinion regarding Sundstrand's obligation to make the purchase) was operating at the same time, because respondents' conduct was an operating cause, Sundstrand was entitled to recover from respondents. Accordingly, the decision below (1) erred in failing to follow *Affiliated Ute Citizens* and (2) was inconsistent with the decisions cited in the preceding paragraph. Review by this Court is necessary to resolve the conflict and to clarify the holding of *Affiliated Ute Citizens*.

B. Correct Application Of This Court's Holding In *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), Demonstrates That There Was No Exculpatory "Superseding" Cause

The Court of Appeals also failed to perceive that its finding of an exculpatory, second cause was in conflict with still another decision of this Court, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

The Court of Appeals *sua sponte* raised the question whether any reliance by Sundstrand on an opinion of counsel to the effect that Sundstrand was contractually obligated to complete the purchase constituted a "superseding cause" which exonerates Sun and Huarisa.* (M.App. 105) The concept of "superseding cause," which in certain limited circumstances will relieve a prior wrongdoer of liability for injury to which his misconduct has made a substantial contribution, was developed in negligence cases at common law. Even in such cases, in order to "supersede" the initial wrongdoer's liability, the later cause must be

* As shown at pp. 21-23, *infra*, not only was the Court of Appeals' finding unsupported by the evidence, but the evidence established that *there was no such opinion.*

one *not* produced or set in motion by the initial wrongful act, but rather must be of independent origin. *Restatement (Second) of Torts*, §§ 440-42 (1965); Prosser, *Law of Torts*, § 44, at 270-71 (4th ed. 1971); *Freeman* v. *United States*, 509 F.2d 626, 633-34 (6th Cir. 1975); 22 Am.Jur.2d, "Damages," § 84 at 120 and § 111 at 161-62 (1965); *Comstock* v. *General Motors Corp.*, 99 N.W.2d 627, 635-36 (Mich.Sup.Ct. 1959).

In the present case, any reliance on counsel was not a "superseding cause" even as that concept has been applied in negligence cases. Regardless of any understanding that Sundstrand may have had concerning the interpretation of the January 9, 1969 agreement with Huarisa, if Sundstrand or its counsel had been informed, before February 6, 1969, of the gross deception in violation of Section 10(b) which had been practiced on Sundstrand by the conspiratorial actions of SKI and Huarisa and which (as both courts held) had induced Sundstrand to enter into the agreement in the first instance, Sundstrand and its counsel would also have known that the agreement with Huarisa was voidable under Section 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b) (S.App. 113), as interpreted by this Court in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382-88 (1970), following *Bankers Life & Cas. Co.* v. *Bellanca Corp.*, 288 F.2d 784, 787 (7th Cir. 1961). Thus, the supposed "superseding" cause of counsel's opinion found by the Court of Appeals would have disappeared altogether had Huarisa or SKI disclosed (or had Sundstrand otherwise learned of) the wrongful conduct found by both courts below. The Court of Appeals' ruling in effect allows respondents to escape liability by reason of a "cause" created by and kept in effect solely by their own continuing misconduct. Therefore, the Court of Appeals erred in holding that there was an exculpatory second, or superseding, cause.

At most, then, any reliance on counsel was a concurrent cause with Sundstrand's reliance on defendants' misrepre-

sentations and omissions. Where harm results from two concurrent, equally sufficient causes, even a negligent wrongdoer is liable regardless of any negligence on the part of the second actor. *Restatement (Second) of Torts,* § 432(2) (followed in *Basko* v. *Sterling Drug, Inc.,* 416 F.2d 417, 429-30 (2nd Cir. 1969)) and §§ 302A, 439 and 442 (1965); 2 Harper & James, *The Law of Torts,* § 20.2 at 1123 (1956); Prosser, *Law of Torts,* § 44 at 274 (4th ed. 1971). Since such a rule embraces merely negligent wrongdoers, *a fortiori* an intentional or reckless wrongdoer should not escape liability under such circumstances.

This Court should grant a writ of certiorari here in order to reaffirm *Mills* and to clarify the role (if any) of the concepts of "concurrent" and "superseding" causes in actions under Rule 10b-5.

II. The Decision Below Is In Conflict With Decisions Of Other Circuits Interpreting This Court's Decision In *Ernst & Ernst v. Hochfelder,* 425 U.S. 183 (1976), As It Relates To Plaintiff's Conduct As A Defense

The decision below is also in conflict with another line of recent appellate decisions under Rule 10b-5. Prior to this Court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 183 (1976), a number of courts had held that a plaintiff's mere lack of diligence in discovering the truth was a defense in an action under Rule 10b-5. E.g., *Clement A. Evans & Co.* v. *McAlpine,* 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); *see generally* Wheeler, "Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy," 70 *Nw.U.L.Rev.* 561 (1975). As a result of *Hochfelder,* which requires proof of scienter on the part of the defendant, however, several Courts of Appeals have reconsidered the due diligence defense.

In *Holdsworth* v. *Strong,* 545 F.2d 687 (10th Cir. 1976) (en banc), *cert. denied,* 97 S.Ct. 1600 (1977), the Court of Appeals held, "[i]f contributory fault of plaintiff is to can-

cel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendants." 545 F.2d at 693. Similarly, in *Dupuy* v. *Dupuy,* 551 F.2d 1005, 1020 (5th Cir. 1977), the court held that a Rule 10b-5 plaintiff will be barred only if his conduct is reckless; the issue is whether the plaintiff "intentionally refused to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow,'" not merely whether plaintiff acted unreasonably. 551 F.2d at 1020. *Contra, Hirsch* v. *duPont,* 553 F.2d 750, 763 (2d Cir. 1977) (plaintiff barred for "fail[ure] to exercise due diligence"), followed in *NBI Mortgage Investment Corp.* v. *Chemical Bank,* CCH Fed. Sec. L.Rep. ¶ 96,066, at p. 91,801 (S.D.N.Y. 1977) [Current Binder] (refused to follow *Holdsworth,* holding that under *Hirsch* "the standard of due diligence is still viable and accepted in this circuit"); *see Straub* v. *Vaisman & Co., Inc.,* 540 F.2d 591, 596-98 (3d Cir. 1976) (the issue is whether plaintiff "acted reasonably"); and *McLean* v. *Alexander,* 420 F.Supp. 1057, 1078 (D.Del. 1976) (plaintiff is "charged with a duty of due diligence commensurate with his investor sophistication"), all after *Hochfelder.*

The opinions cited above demonstrate that, depending on the court in which he sues, a plaintiff may be barred from recovery merely for failing to exercise diligence, or for acting unreasonably or only for acting recklessly. This aspect of the implications of *Hochfelder* is clearly ripe for, and merits, review by this Court.

In the instant case, the Court of Appeals purported to adopt the *Holdsworth* test (M.App. 100), but neither the result nor the court's reasoning accorded with that standard. There is no basis for a conclusion that Sundstrand acted recklessly or with gross conduct, and neither court below so found. While the Court of Appeals suggested that Sundstrand had some information contrary to defendants' repre-

sentations (M.App. 82-83, 104), in fact, as the District Court found, "[t]here is no evidence whatsoever that Sundstrand had actual knowledge of the fraud being perpetrated upon it," and its reliance on defendants' statements was "entirely reasonable." (M.App. 57, 58) Sundstrand's difference of opinion with SKI on the exact magnitude of SKI's likely earnings for 1968* does not constitute any bar to Sundstrand's recovery under the standard enunciated in *Holdsworth* and *Dupuy*. Any reliance on an erroneous legal opinion would also not have been gross or reckless conduct.

Contrary to the evidence, the Court of Appeals found that Sundstrand "had learned enough to apprise it that forfeiture of its down payment was better than further payments" under the agreement with Huarisa. (M.App. 104) The evidence is clear that Sundstrand in fact concluded, after the termination of merger negotiations and before the February 6 payment, that purchase of the SKI shares was "a good investment." (Schuette Dep. 330-33, 336-37, Miller at Trial Tr. 749-52, S.App. 155-159, all of which was in evidence) In addition, as the District Court found, Huarisa had advised Sundstrand, albeit falsely, that other companies had offered $45 per share for SKI, and the $30 per share price was far below Sundstrand's own $38.25 merger proposal. (M.App. 10) At most, the contrary conclusion of the Court of Appeals reflects a difference of opinion on a matter of business judgment, which is a patently inadequate basis under *Holdsworth* and *Dupuy* for overturning the District Court's damage award.

By thus purporting to adopt a high standard of proof to establish the defense (*Holdsworth*) but in fact applying

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* While Sundstrand lacked confidence in Huarisa's statement that SKI's 1968 earnings would be $1.16 per share, Sundstrand merely concluded that SKI was more likely to earn $.80 to $1.00 a share and, because that conclusion was based on the numerous false statements and omissions of SKI and Huarisa which Sundstrand believed to be true, it had no inkling that SKI would *lose* $.15 per share. (M.App. 23)

a low standard of proof, the Court of Appeals watered down the "gross conduct" test so as to evade an obvious implication of the holding in *Hochfelder*—an erosion no less pernicious for its indirectness.* This Court should resolve the conflict involving five Courts of Appeals and determine the parameters of any defense in Rule 10b-5 actions based on plaintiff's conduct.**

III. The Court Of Appeals' Reversal Of The District Court Based Upon The Court Of Appeals' Independent Examination of Material Not In The Trial Record Conflicts With Decisions Of Other Circuits And Warrants Exercise Of This Court's Supervisory Power.

The Court of Appeals' ruling that Sundstrand was not entitled to recover damages for the February 6, 1969 payment was based on that court's finding that Sundstrand consummated the purchase "only" because it believed, based on an opinion of counsel, that it was legally obligated to do so. (M.App. 103) This finding, developed from that court's "independent study of the record" (M.App. 103), was in the face of the District Court's contrary findings on reliance and causation.*** *This crucial finding of reliance on an opinion of counsel, a finding the defendants did not*

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* The approach by this panel of the Court of Appeals should be contrasted with the admonition of another panel of the same court:

> [T]he definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind. *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790, 793 (7th Cir. 1977) (on remand from Supreme Court).

** Meers, petitioner in the related case, No. 77-83, presents a similar question in his Question No. 2.

*** *See, e.g.*, M.App. 56-58. In this ruling, the Court of Appeals also failed to adhere to the requirements of Rule 52(a), F.R.Civ.P., that "findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."

seek and no party briefed on appeal, was expressly, indeed blatantly, predicated upon material not in the trial record and thus not within the Court of Appeals' scope of review.

The Court of Appeals' express ruling that it can independently consult evidentiary material not in the trial record and make its own findings of fact based thereon (S.App. 111) is in square conflict with decisions of other Courts of Appeals. (*See* pp. 22-23, *infra*) Moreover, such conduct constitutes, in the words of Supreme Court Rule 19, a "depart[ure] from the accepted and usual course of judicial proceedings . . . [so far] as to call for an exercise of this Court's power of supervision."

> This Court is charged with supervisory functions in relation to proceedings in the federal courts. See McNabb v. United States, 318 U.S. 332, 63 S.Ct. 608, 87 L.Ed. 819. Therefore, fastidious regard for the honor of the administration of justice requires the Court to make certain that the doing of justice be made so manifest that only irrational or perverse claims of its disregard can be asserted. (*Communist Party* v. *Subversive Activities Control Board,* 351 U.S. 115, 124 (1956).)

This Court should exercise its supervisory powers in order to prevent the conduct by the Court of Appeals herein from becoming a pernicious precedent for appellate review of findings of fact.

The court below cited numerous references to the record on appeal* to support the result of its "independent study of the record." (M.App. 104 n. 35 and S.App. 112) But of the twenty-five citations therein to transcript or deposition pages, only five were to trial testimony or to depositions *in evidence.* (The texts of the twelve passages of the twenty-five which are in the trial record are set forth in the

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* Pursuant to Rule 10(a), F.R.App.P., the record on appeal included all papers filed in the District Court since this case was commenced in 1969. *International Business Machines Corp.* v. *Edelstein,* 526 F.2d 37, 45 (2d Cir. 1975).

appendix to this petition at S.App. 116-147) The Court of Appeals' only citations to evidence in the trial record were Trial Tr. 131, 165-67, 484-87 and 625-31 and Huarisa Dep. 229-30. (S.App. 116-128, 146-147) Only two of these five passages in evidence so much as refer to an opinion of counsel. Neither of the two supports the Court of Appeals' finding that the "only" or "principal reason" Sundstrand completed the purchase was "because counsel had wrongly advised Sundstrand officials that it was legally obligated" to make the purchase.* (M.App. 103) There is no other *evidence* in the *trial record* bearing on any opinion of counsel. The remaining citations to the trial transcript in original footnote 35 of the Court of Appeals opinion are to argument of counsel or to colloquy. (S.App. 128-146) The other thirteen citations are to deposition passages not admitted or even offered into evidence at trial.

Other Courts of Appeals have consistently held that they cannot consider evidentiary material not in the actual trial record in appraising the District Court's findings, much less to formulate their own findings of fact. *United States* v. *City of Brookhaven,* 134 F.2d 442, 446-47 (5th Cir. 1943) (depositions not in evidence could not be considered by reviewing court even though they were included in the record on appeal); *Worsham* v. *Duke,* 220 F.2d 506, 509 (6th

* During cross-examination of Sadler, a Sundstrand officer, counsel for Sun and Huarisa read a passage of Sadler's deposition to refresh his recollection. Sadler had testified at the deposition that Ethington, another Sundstrand officer, told Sadler that counsel felt Sundstrand was obligated to buy the stock. Sadler's recollection was not refreshed. (Tr. 484-87, S.App. 119-122) During cross-examination of Ross, counsel for Sun and Huarisa sought indirectly to *impeach* Ethington by having Ross, a Sundstrand officer, identify Sundstrand's interrogatory answer (Sun-Huarisa Ex. 52, set forth in full in the appendix to this petition at S.App. 148-151), in which Sundstrand ***DENIED that it had received an opinion of counsel in this regard.*** (Tr. 625-31, S.App. 122-128) These two references provide no basis for rejecting the District Court's findings of reliance and causation. Indeed, such evidence established that there was no reliance on any such opinion because ***there was no opinion.***

Cir. 1955). *See also Rommel-McFerran Co. Inc.* v. *Local U. No. 369 Int. Bro. of Elec. Wkrs.*, 361 F.2d 658, 661-62 (6th Cir. 1966). On a previous occasion even the Court of Appeals which decided the instant case recognized this fundamental principle of appellate review. *Charles* v. *Judge & Dolph, Ltd.*, 263 F.2d 864, 867 (7th Cir. 1959).

This Court has recently criticized Courts of Appeals for relying on material not developed in the record before an administrative agency when reviewing a determination by the agency. *E. I. du Pont de Nemours & Company* v. *Collins*, 97 S.Ct. 2229, 2235 (1977) (court erred in retaining professor after oral argument to prepare reports which "had not been examined and tested by the traditional methods of the adversary process"); *F.P.C.* v. *Transcontinental Gas Pipe Line Corp.*, 423 U.S. 326, 331-32 (1976).

The unfairness of the approach by the Court of Appeals here is manifest, since Sundstrand never needed, and therefore made no effort, to rebut or to explain the material not in evidence. In any event, the evidence in the trial record, introduced by defendants, established that no legal opinion was sought or received by Sundstrand, and none was relied on.

When the Court of Appeals denied Sundstrand's petition for rehearing en banc on May 18, 1977 by a divided vote both of the members of the panel which decided the case and of other Circuit Judges, the court expanded its footnote 35 by citing cases which purportedly justify such an excursion beyond the trial record and by citing two instances where Sundstrand referred in briefs to material not in evidence.* (S.App. 111-112) The court's effort to justify its impermissible approach lacks any persuasive force.

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* The two cited instances when Sundstrand referred to filings not in evidence were references to an interrogatory answer and to a brief in the trial court. (These excerpts are set forth in the appendix to this petition at S.App. 152-154) These were cited to show contentions made in the District Court. In neither instance did Sundstrand even purport to rely on those portions of the record on appeal as evidence to prove an evidentiary fact in issue.

The opinion in *Lyon* v. *Carey*, 533 F.2d 649, 652 (D.C. Cir. 1976), does not indicate what use the District Court made of the deposition which was referred to by the Court of Appeals, but it appears that the portion of the deposition on which the Court of Appeals relied pertained to facts not in dispute on appeal. In *Merola* v. *Atlantic Richfield Company*, 515 F.2d 165, 170-71 (3d Cir. 1975), the Court of Appeals made reference to depositions in order to provide the District Court with some guidance in connection with proceedings upon remand. (In the instant case the Court of Appeals made a final determination on a factual issue without ordering a remand.) Moreover, in that case (unlike this case) it was not clear what had been and had not been included in the trial record. Finally, in *Barrett* v. *Baylor*, 457 F.2d 119, 124 n. 2 (7th Cir. 1972), the Court of Appeals considered pleadings—not depositions—in an action in a related state case which, the court noted, were properly the subject of judicial notice in any event. In short, nothing in the expanded footnote 35 excuses the Court of Appeals' egregious departure from the confines of the trial record.

This Court should grant this petition in the exercise of its supervisory powers over lower federal courts and reverse the judgment below.

CONCLUSION

For the reasons given, petitioner Sundstrand Corporation prays that a writ of certiorari be granted to review the judgment and opinion below.

Respectfully submitted,

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